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ABSTRACT

Designed for high school economics students as a public service project of the American Fletcher National Bank, the booklet examines the fundamentals of the profit system in attempts to dispel common misconceptions held by students. A comparison is made between newspaper carriers and big business entrepreneurs by considering the risks made in investing one's money and energy in an effort to make a profit. Next, reasons for overestimation by the public of the profits of business are pointed out: (1) glowing and often misleading annual reports by corporations; (2) misunderstanding of the terms, "gross profit" and "net profit"; and (3) underestimating the amount corporations pay in federal taxes, labor, shareholder dividends, equipment and expansion. Former newspaper carriers like George McGinnis, Bob Hope, Johnny Bench, John Wayne, former President Herbert Hoover, astronaut John Glenn, and Willie Mays are listed as examples of the way the entire business system in America has grown from humble beginnings to being the most productive, efficient economic system in the world today. The importance to the free enterprise system of competition for profit maximization is stressed. The document emphasizes that well over 90 percent of all the resources available to the federal government for aid to the sick and elderly, for military security, and for countless welfare programs come ultimately from the productivity of the American business system and the profit motive. (LH)

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PLAIN TALK ABOUT PROFITS

FUNDAMENTALS OF FREE ENTERPRISE

No. 2 Revised

1982

American Fletcher National Bank and Trust Co.
Indianapolis, Indiana

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PROLOGUE

A Rising Tide Lifts All Boats *is the seventh booklet in the "Fundamentals of Free Enterprise" series produced by American Fletcher National Bank.*

A public service project of the bank, the series is designed primarily for high school students. It is distributed free to Marion County high schools—and at cost to other organizations desiring copies.

The booklets seek to interpret some of the economic principles which have enabled America to achieve world greatness. They also analyze timely economic issues which should be of interest to every American.

The "Fundamentals of Free Enterprise" series is a continuing project of American Fletcher. We invite your comments and suggestions about the series and how it can be more helpful.

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Other booklets in American Fletcher's "Fundamentals of Free Enterprise" series include:

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Question: Do you know what George McGinnis, Bob Hope, Johnny Bench, John Wayne, former President Herbert Hoover, astronaut John Glenn and Willie Mays all have in common?

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Answer: They are but a handful of famous Americans who got their start in life as newspaper carriers.

These illustrious figures—and thousands more like them—learned something important about life at a very early age—how to go into business for themselves to earn an income and make a profit. They learned that making money through careful planning and hard work is nothing to be ashamed of. In short, they learned that making a "profit" was a rewarding experience.

In recent years, the profit motive has fallen on hard times. Even the word "profit" has become one of the most misunderstood terms in the English language. Some critics have come to the point of questioning whether companies should be allowed to make profits, preferring instead some form of a socialist state where the government owns and operates the major means of production and services. Others believe that private enterprise is alright but that profits are excessive.

A Gallup survey recently disclosed, for example, that high school juniors and seniors

estimated that the profit made by a typical corporation is about 30 percent and that college juniors and seniors place the figure at about 45 percent.

George Gallup concluded: "College students today grossly *overestimate* the profits of business, grossly *underestimate* the share of all dollars going to labor and grossly *underestimate* the amount that corporations pay in federal taxes. No wonder that so many hold anti-business views."

The truth is, of course, that these representative students are far off the mark. Instead of 45 percent—or even 30 percent—a typical corporation makes only five to six percent as profit margin. The students, however, should not be held responsible for these distorted ideas. Their false notions really can be laid to failure of the business world to tell its own story and to a weakness in our educational system, the inability to teach basic economics or how the American business system works.

Let's look at some fundamentals of the profit system which apparently have never been communicated effectively.

First, too few understand the risks associated with investing one's money and energy in an effort to make profit. Those famous Americans cited at the outset as former news carriers surely understand the element of risk because they took that risk.

In an effort to make profit, a news carrier must become an entrepreneur in the full sense of the word—like every small businessman. The dictionary defines an entrepreneur as "one who assumes the risk and management of business," an apt description of the process a news carrier goes through.

He first must make a financial investment—usually a $60 or $75 deposit with the newspaper publisher—just to get the route. Then he buys so many newspapers each day at a reduced (wholesale) price. Through his own labor, the carrier adds value to the newspaper by providing the service of delivering it and is thus able to charge each customer a higher price than he paid for it. If all goes well, this extra value becomes the carrier's profit.

But before there can be profit, the carrier must first collect from all his customers. If

he doesn't, he still must pay the newspaper each week for the copies delivered.

Every carrier can tell you of customers who delay payments week after week, or who simply move out, leaving behind substantial debts. These customers increase the carrier's cost of doing business and force him to go into his own savings to make up the difference.

Thus, even with a newspaper carrier, there is risk associated with investing to make a profit. Many who try fail miserably for a variety of reasons. Similarly, in larger business ventures there is risk; 60 percent of all new companies in the United States fail in the first 30 months because they fail to make profits.

The profits of a news carrier also are affected by competition. If people along his route subscribe to competing newspapers, that cuts into his market and reduces his chances for greater profits. Thus, to compete effectively, he is compelled to improve his service—little things like leaving the newspaper inside the front door instead of tossing it carelessly in the yard, or making sure it doesn't blow away in the wind.

The one who benefits in the end, of course, is the consumer. And that's what the profit system is all about—competition in the marketplace to give the consumer the goods and services he wants at the lowest possible price. When goods and services in demand are scarce, it keeps prices up. When the market becomes glutted with too many competing products and services, it forces prices down. The ultimate winner in this free, competitive process is the consumer.

Carrying a newspaper, one of America's fundamental enterprises, is a useful illustration of the system at work. Little wonder that former President Eisenhower concluded on one occasion: "The tradition of the newspaper carrier is peculiarly American. It is a tradition which reflects our American appreciation of the values of individual industry, of diligence learned at an early age, later to be applied throughout the length of one's career."

We must discuss larger units in the business system, however, to analyze some of the other misconceptions about the profit system.

Let's begin with the criticism that profits often are too high. This complaint is often heard after some major corporation releases its annual statement, showing that profits are up 50 percent over the previous year and that sales volume increased markedly. Unfortunately, such figures are frequently misleading.

Terms used on the financial page of the daily newspaper can be deceptive unless one knows his way around in the semantics jungle.

In its simplest form, the word "profit" means what a company makes after it has paid all expenses. But that definition is too simple to be meaningful.

First, one must know the difference between *gross* profits and *net* profits. Gross profits are the difference between what a business pays for its raw materials and what it charges for the finished product. If a merchant or producer buys $1 million worth of materials in a year, for example, and later sells the finished product or service for $1,350,000, his gross profit is $350,000—or 35 percent.

Net profit, on the other hand, is what is left after *all* expenses have been paid—such

as wages, rent, heat, lights, interest on loans and repairs. Let's assume that those items all total $250,000. Thus, this amount subtracted from the $350,000 in gross profit leaves a net profit of $100,000—or 10 percent. But our story doesn't end there.

From the $100,000, our merchant must pay federal and state corporate profit taxes—usually about 45 to 50 percent. That leaves about $50,000. From that amount he also must pay dividends to shareholders who have invested their own money in the company and expect some return on their money. Let's say that $25,000 is paid out in dividends to the owner of the enterprise. This leaves our merchant with only $25,000 from the original $350,000 gross profit—a 2.5 percent improvement over his original investment of $1 million. From that $25,000, he must set aside $12,500 to go back into the company for new equipment and expansion.

The so-called "bottom line" in this mythical situation, therefore, is that from $1,350,000 in sales our merchant is left with the magnificent sum of $12,500 or 1.25 percent over his original investment of $1 million.

To have read about this company, with its gross profit of 35 percent—or even its net profit of 10 percent—we could have concluded that profits were too high. But were they really in the final tally, the "bottom line?"

Some corporations contribute unwittingly to anti-business sentiment in America by permitting their profit picture to be painted so glowingly that they are misleading about the end result. Their motives in doing so are sincere, for they hope to attract more people to invest in their companies by showing high earnings. But such maneuvers often play into the hands of critics who would like to eliminate the profit system because, in their view, it exploits the consumer.

Similarly, we may hear that a company increased its earnings this year by 200 percent. But that leaves a question: 200 percent more than what? It could have been 200 percent over the worst year in the company's history, which still leaves it in serious financial straits.

For example, a firm could sell $1 million worth of products in a year and be left with a net

profit of only $20. If the net profit from the previous year on exactly the same sales volume were only $10, the company technically has had a 100 percent increase in earnings. A whopping increase indeed—but dangerously deceptive. Little wonder that many Americans, reading such percentages, are outraged by "excessive" profits.

The truth is, however, that critics of the system are not even in the ball park when they estimate such high percentages of profit. The total net profits after taxes of all American corporations in 1980 was $163 billion—or about five percent of sales. That's about the same return investors would have received if they had put their money in a bank savings account. So what's "excessive" about it?

Because of the confusion in the public mind, some major corporate executives want to eliminate the term "profit." Reginald H. Jones, chief executive officer of General Electric, says:

"Uninformed critics have so perverted the meaning of the word 'profits' in the public mind that it has come to mean something like 'undeserved income' or the 'exploiter's unjust reward' . . . Almost half of what are called profits are really the government's take from the operations of a business, the

corporation's income tax. The part paid out in dividends is really 'interest on equity,' a fee paid for the use of people's savings, essentially no different from interest paid on loans. And the remainder—the profits reinvested in the business—are just as well called 'business savings' or 'reinvested earnings' . . . People understand such things as taxes, interest, earnings and savings, because they are all part of the family budget. But nobody in the family thinks of profits. They are considered something alien, received only by the undeserving businessman."

Perhaps Mr. Jones is right. Maybe it is time to find another way of describing what the American free enterprise system is all about. Whatever you call it, however, it is an indispensable part of the way our system works. Profit is the fuel which fires the engine of our entire society. Without it, even the government would collapse. If you doubt it, consider where the nation's resources come from.

Our federal government collected more than $520 billion in taxes in 1980 to finance all its programs. Of that figure, more than $64 billion came from corporate income taxes—from the profits of business. More than $244 billion came from individual income taxes—most of which can be traced back to salaries and wages from

businesses established to make a profit. More than $160 billion came in payments to the Social Security program and other federal insurance funds—the bulk of which again originate from business. And $24 billion came in excise taxes on goods and services produced by business. (The balance of $28 billion came from estate and gift taxes, customs duties and miscellaneous sources.)

Thus, well over 90 percent of all the resources available to the federal government—for aid to the sick and elderly, for education, for military security, for countless welfare programs—come ultimately from the productivity of the American business system and the profit motive.

The same can be said for state and local government, which also must rely on the productivity of the business world for their resources. Altogether, all levels of government absorb through taxes nearly 40 percent of the Gross National Product—the combined value of all goods and services in the United States. It would be *zero* percent without the profit system, for there would be nothing to tax.

Or, to use the words of a Minnesota insurance executive, "If there were no hope for profits, there would be no business . . . no jobs and no government dollars to devote to social purposes."

The American free enterprise system is the most efficient means of managing the production and distribution of goods and services in the history of man. Consequently, Americans enjoy the highest living standards the world has ever seen.

Profits play a key role in that system because they ultimately determine which goods and services are to be produced. Consumers with their dollar vote shape the marketplace by preferring some products over others. Those businessmen who correctly anticipate consumer wishes, and provide for them at reasonable cost, earn profits. Those who fail this basic test suffer losses—and they either adjust to consumer demands or they go out of business.

Profits also are a boost to our economy because they spark the search for new products and better materials—and the consumer is the final beneficiary.

Two distinguished American historians, as they recently concluded more than 40 years of studying the civilizations of man, summarized their thoughts in a book titled *The Lessons of History*.

Commenting on man's economic history, Will and Ariel Durant wrote: "The experience of the past leaves little doubt that every economic system must sooner or later rely upon some form of the profit motive to stir individuals and groups to productivity. Substitutes like slavery, police supervision or ideological enthusiasm prove too unproductive, too expensive or too transient."

Whether it's a news carrier on your street or General Motors, the lesson is the same—and always will be. Making a profit is fundamental to our free enterprise system. In fact, profit is one of the most important words--and concepts—in our vocabulary. It behooves all of us to understand the word more fully, for in a very real sense our whole future depends on it.